

AMENDED IN ASSEMBLY JUNE 30, 2003

AMENDED IN SENATE APRIL 10, 2003

SENATE BILL

No. 1061

**Introduced by Committee on Revenue and Taxation (Senators
Cedillo (Chair), Alpert, Bowen, and Burton)**

February 27, 2003

An act to amend Sections 2205 and 5008.6 of the *Corporations Code*, to amend Section 7073.8 of the *Government Code*, and to amend Sections 23041 and 25111 of, and to add Sections 18405.1, 25113, and 25116 to, the Revenue and Taxation Code, relating to taxation, to take effect immediately, tax levy.

LEGISLATIVE COUNSEL'S DIGEST

SB 1061, as amended, Committee on Revenue and Taxation. ~~Corporation~~ *Suspended corporations: corporation taxes: water's-edge.*

~~The~~

(1) The Corporations Law allows the Secretary of State to suspend the powers, rights, and privileges of a corporation, if the corporation fails to pay taxes or fails to file tax returns, annual returns, or certain other information returns. The Corporations Law precludes a suspended corporation from filing an application for tax-exempt status or amending its articles of incorporation to perfect its tax-exempt application.

This bill would permit a corporation to file an application for tax-exempt status even if the status of the corporation is suspended. This bill would also allow a suspended corporation to amend its articles of incorporation to perfect its application for tax-exempt status.

(2) *The Corporation Tax Law* allows corporations to elect whether their income is determined on a “water’s-edge” basis or on a worldwide unitary basis. The election to report income on a water’s-edge basis is made by contract between the taxpayer and the Franchise Tax Board. The contract requirements allow no relief for errors, and do not allow the perfecting of invalid water’s-edge elections. Electors who fail to comply with the contractual requirements for making a water’s-edge election forfeit their water’s-edge election, thereby causing their income to be determined on a worldwide unitary basis.

This bill would revise water’s-edge election procedures by, among other things, providing that elections made under current law may be perfected, and by providing, for taxable years beginning on or after January 1, 2003, that elections be made by statutory election, as provided, rather than by contract.

This bill would take effect immediately as a tax levy.

Vote: majority. Appropriation: no. Fiscal committee: yes. State-mandated local program: no.

The people of the State of California do enact as follows:

1 SECTION 1. *Section 2205 of the Corporations Code is*
2 *amended to read:*

3 2205. (a) A corporation that (1) fails to file a statement
4 pursuant to Section 1502 for an applicable filing period, (2) has not
5 filed a statement pursuant to Section 1502 during the preceding 24
6 months, and (3) was certified for penalty pursuant to Section 2204
7 for the same filing period, ~~shall be~~ *is* subject to suspension
8 pursuant to this section rather than to penalty pursuant to Section
9 2204.

10 (b) When subdivision (a) is applicable, the Secretary of State
11 shall mail a notice to the corporation informing the corporation
12 that its corporate powers, rights, and privileges will be suspended
13 after 60 days if it fails to file a statement pursuant to Section 1502.

14 (c) After the expiration of the 60-day period without any
15 statement filed pursuant to Section 1502, the Secretary of State
16 shall notify the Franchise Tax Board of the suspension; and mail
17 a notice of the suspension to the corporation, and thereupon,
18 ~~except for the purpose of amending the articles of incorporation to~~
19 ~~set forth a new name;~~ the corporate powers, rights, and privileges
20 of the corporation are suspended, *except for the purpose of filing*

1 *an application for exempt status or amending the articles of*
2 *incorporation as necessary either to perfect that application or to*
3 *set forth a new name.*

4 (d) A statement pursuant to Section 1502 may be filed
5 notwithstanding suspension of the corporate powers, rights, and
6 privileges pursuant to this section or Section 23301 ~~or~~, 23301.5,
7 *or* 23775 of the Revenue and Taxation Code. Upon the filing of a
8 statement pursuant to Section 1502 by a corporation that has
9 suffered suspension pursuant to this section, the Secretary of State
10 shall certify that fact to the Franchise Tax Board and the
11 corporation may thereupon be relieved from suspension unless the
12 corporation is held in suspension by the Franchise Tax Board by
13 reason of Section 23301 ~~or~~, 23301.5, *or* 23775 of the Revenue and
14 Taxation Code.

15 SEC. 2. *Section 5008.6 of the Corporations Code is amended*
16 *to read:*

17 5008.6. (a) A corporation that (1) fails to file a statement
18 pursuant to Section 6210, 8210, or 9660 for an applicable filing
19 period, (2) has not filed a statement pursuant to Section 6210,
20 8210, or 9660 during the preceding 24 months, and (3) was
21 certified for penalty pursuant to Section 6810, 8810, or 9690 for
22 the same filing period, shall be subject to suspension pursuant to
23 this section rather than to penalty under Section 6810 or 8810.

24 (b) When subdivision (a) is applicable, the Secretary of State
25 shall mail a notice to the corporation informing the corporation
26 that its corporate powers, rights, and privileges will be suspended
27 60 days from the date of the notice if the corporation does not file
28 the statement required by Section 6210, 8210, or 9660.

29 (c) If the 60-day period expires without the delinquent
30 corporation filing the required statement, the Secretary of State
31 shall notify the Franchise Tax Board of the suspension, and mail
32 a notice of the suspension to the corporation. Thereupon, except
33 for the purpose of *filing an application for exempt status or*
34 *amending the articles of incorporation as necessary either to*
35 *perfect that application or to set forth a new name* ~~or filing an~~
36 ~~application for exempt status~~, the corporate powers, rights, and
37 privileges of the corporation are suspended.

38 (d) A statement required by Section 6210, 8210, or 9660 may
39 be filed, notwithstanding suspension of the corporate powers,
40 rights, and privileges under this section or under provisions of the

Revenue and Taxation Code. Upon the filing of a statement under Section 6210, 8210, or 9660, by a corporation that has suffered suspension under this section, the Secretary of State shall certify that fact to the Franchise Tax Board and the corporation may thereupon be relieved from suspension, unless the corporation is held in suspension by the Franchise Tax Board because of Section 23301, 23301.5, or 23775 of the Revenue and Taxation Code.

SEC. 3. Section 7073.8 of the Government Code is amended to read:

7073.8. (a) The agency shall designate up to two Manufacturing Enhancement Areas, as defined by Section 17053.47 of the Revenue and Taxation Code, requested by the governing boards of cities each of which shall meet at least the following criteria:

(1) The unemployment rate in the county in which the applicant is located has been at least three times the state average from 1990 to 1995, inclusive.

(2) The applicant city is, or portions of the city are, designated a federal enterprise community or empowerment zone pursuant to Subchapter U (commencing with Section 1391) of Chapter 1 of Subtitle A of Title 26 of the United States Code.

(3) The applicant city is located in a Border Environment Cooperation Commission region as specified in Section 3473 of Title 19 of the United States Code.

(4) At least one of the following:

(A) The designated area has grown by less than 5 percent in population per year for each of the two years preceding the application date.

(B) The median household income for the designated area is under twenty-five thousand dollars (\$25,000) per year.

(C) The designated area has a population of under 20,000 persons according to the 1990 federal census.

(D) The designated area is located in a rural community.

(5) An audit of the program shall be made at the end of the 5th and 10th year of its operation by the Trade and Commerce Agency with the cooperation of the local governing board. The audit shall be used to determine how effective the designation has been in attracting manufacturing facilities and creating new employment opportunities. Continuation of the designation is contingent on evidence of success of the program.

(b) For purposes of applying any provision of the Revenue and Taxation Code, any Manufacturing Enhancement Area designated pursuant to this section shall not be considered an enterprise zone designated pursuant to this chapter.

(c) The designation as a Manufacturing Enhancement Area pursuant to this section shall be binding for a period of 15 years, commencing January 1, 1998.

SEC. 4. Section 18405.1 is added to the Revenue and Taxation Code, to read:

18405.1. (a) Notwithstanding Section 18405, the Franchise Tax Board may, in its discretion, permit elections made under Section 25111 to be perfected during the period of limitations prescribed under Sections 19057 and 19306 for the applicable taxable year. The statute of limitations of all taxpayers in a water's-edge group whose taxable year falls, in whole or in part, within the period of the election shall remain open to receive adjustments, under claim or deficiency, consistent with that perfection of the election.

(b) Subdivision (a) does not apply to the 1988 taxable year of any taxpayer whose water's-edge election has been perfected pursuant to Section 18405.

~~*SEC. 2.*~~

SEC. 5. Section 23041 of the Revenue and Taxation Code is amended to read:

23041. "Taxable year" means:

(a) For the purposes of the tax imposed under Chapter 2 (commencing with Section 23101), the calendar year, or the fiscal year for which the tax is payable.

(b) For the purposes of the tax imposed under Chapter 1.5 (commencing with Section 23081), Chapter 3 (commencing with Section 23501), or Chapter 4 (commencing with Section 23701), the calendar year or the fiscal year upon the basis of which the net income is computed.

(c) For purposes of the tax imposed under Chapter 2.5 (commencing with Section 23400), (1) in the case of a taxpayer subject to the tax imposed under Chapter 2 (commencing with Section 23101), the calendar year or the fiscal year for which the tax is payable and (2) in the case of a taxpayer subject to the tax imposed under Chapter 3 (commencing with Section 23501) or

1 Chapter 4 (commencing with Section 23701), the calendar or
2 fiscal year upon the basis of which the net income is computed.

3 (d) For the purpose of the taxes imposed under this part, a
4 period of 12 months or less.

5 (e) When referring to a calendar or fiscal year beginning before
6 January 1, 2000, upon the basis of which the net income is
7 computed, the term “taxable year” shall mean “income year,” as
8 defined in subdivision (a) of Section 23042.

9 ~~SEC. 3.—~~

10 *SEC. 6.* Section 25111 of the Revenue and Taxation Code is
11 amended to read:

12 25111. (a) For taxable years beginning before January 1,
13 2003, the making of a water’s-edge election as provided for in
14 Section 25110 shall be made by contract with the Franchise Tax
15 Board in the original return for a year and shall be effective only
16 if every taxpayer that is a member of the water’s-edge group and
17 which is subject to tax under this part makes the election. A single
18 taxpayer that is engaged in more than one business activity subject
19 to allocation and apportionment as provided in Article 2
20 (commencing with Section 25120) of Chapter 17 may make a
21 separate election for each business. The form and manner of
22 making the water’s-edge election shall be prescribed by the
23 Franchise Tax Board. Each contract making a water’s-edge
24 election shall be for an initial term of 84 months, except as
25 provided in subdivision (b). Each contract shall provide that on the
26 anniversary date of the contract or any other annual date specified
27 by the contract a year shall be added automatically to the initial
28 term unless notice of nonrenewal is given as provided in
29 subdivision (d). An affiliated corporation that is a member of the
30 water’s-edge group and subsequently becomes subject to tax under
31 this part or is a nonelecting taxpayer that is subsequently proved
32 to be a member of the water’s-edge group pursuant to a Franchise
33 Tax Board audit determination, as evidenced by a notice of
34 deficiency proposed to be assessed or a notice of tax change, shall
35 be deemed to have elected.

36 No water’s-edge election shall be made for a taxable year
37 beginning prior to January 1, 1988.

38 (b) A water’s-edge election may be terminated by a taxpayer
39 prior to the end of the 84-month period if either of the following
40 occurs:



(1) The taxpayer is acquired directly or indirectly by a nonelecting entity which alone or together with those affiliates included in its combined report is larger than the taxpayer as measured by equity capital.

(2) With the permission of the Franchise Tax Board.

(c) In granting a change of election, the Franchise Tax Board shall impose any conditions that are necessary to prevent the avoidance of tax or to clearly reflect income for the period the election was, or was purported to be, in effect. These conditions may include a requirement that income, including dividends paid from income earned while a water's-edge election was in effect, which would have been included in determining the income of the taxpayer from sources within and without this state pursuant to Section 25101 but for the water's-edge election shall be included in income in the year in which the election is changed.

(d) If the taxpayer desires in any year not to renew the election, the taxpayer shall serve written notice of nonrenewal upon the board at least 90 days in advance of the annual renewal date. Unless that written notice is provided to the board, the election shall be considered renewed as provided in subdivision (a).

(e) If the taxpayer serves notice of intent in any year not to renew the existing water's-edge election, that existing election shall remain in effect for the balance of the period remaining since the original election or the last renewal of the election, as the case may be.

(f) To the extent that a taxpayer would have been required to file on a water's-edge basis in its first taxable year beginning on or after January 1, 2003, pursuant to a water's-edge election made in a prior year under this section, the terms of this section no longer apply and that election shall be deemed to have been made under the terms of Section 25113. However, the commencement date of the election made in a prior year under this section shall continue to be treated as the commencement date of the water's-edge election period for purposes of applying the provisions of Section 25113.

~~SEC. 4.~~

SEC. 7. Section 25113 is added to the Revenue and Taxation Code, to read:

25113. (a) Except as provided in subdivision (f), for taxable years beginning on or after January 1, 2003, the election provided

1 for in Section 25110 shall be made on an original, timely filed
2 return for the year of the election. The election will be considered
3 valid if both of the following conditions are satisfied:

4 (1) The tax is computed in a manner consistent with a
5 water's-edge election.

6 (2) A written notification of election is filed with the return on
7 a form prescribed by the Franchise Tax Board. Pursuant to
8 regulations promulgated under this section, the Franchise Tax
9 Board may accept the filing of other objective evidence that
10 supports the conclusion that a water's-edge election was intended
11 in lieu of notification on the designated form.

12 (b) Except as otherwise provided, a water's-edge election shall
13 be effective only if made by every member of the self-assessed
14 combined reporting group that is subject to taxation under this
15 part.

16 (1) An election made on a group return of a self-assessed
17 combined reporting group shall constitute an election by each
18 taxpayer member included in that group return, unless one of those
19 taxpayers files a separate return in which no election is made and
20 paragraph (2) does not apply.

21 (2) A taxpayer that fails to make an election on its own timely
22 filed original return shall be deemed to have elected if either of the
23 following apply:

24 (A) It has a parent corporation that is an electing taxpayer that
25 included the income and apportionment factors of the nonelecting
26 taxpayer in the self-assessed combined reporting group reflected
27 in the electing parent's timely filed original return, including a
28 group return.

29 (B) The income and apportionment factors of the nonelecting
30 taxpayer is reflected in the self-assessed combined reporting group
31 of a timely filed original return of an electing taxpayer, and the
32 notification of election filed by the electing taxpayer pursuant to
33 paragraph (2) of subdivision (a) is signed by an officer or other
34 authorized agent of either a parent corporation of the nonelecting
35 taxpayer or another corporation with authority to bind the
36 nonelecting taxpayer to an election.

37 (3) For purposes of this subdivision, a "parent corporation" of
38 the taxpayer is a corporation that owns or constructively owns
39 stock possessing more than 50 percent of the voting power of the

1 taxpayer as determined under subdivisions (e) and (f) of Section
2 25105.

3 (4) If a corporation that is a member of a combined reporting
4 group is not itself subject to taxation under this part in the year for
5 which the water's-edge election is made, but subsequently
6 becomes subject to taxation under this part, that corporation shall
7 be deemed to have elected with the other taxpayer members of the
8 combined reporting group.

9 (5) A taxpayer that is engaged in more than one apportioning
10 trade or business as defined in paragraph (6) of subdivision (d) of
11 Section 25128 may make a separate election for each apportioning
12 trade or business.

13 (c) A water's-edge election shall remain in effect or be
14 terminated in accordance with this subdivision.

15 (1) Except as otherwise provided in this subdivision, if one or
16 more electing taxpayer members of a combined reporting group
17 later become disaffiliated or otherwise cease to be included in the
18 combined reporting group, the water's-edge election shall remain
19 in effect as to both the departing taxpayer members and any
20 remaining taxpayer members.

21 (2) If an electing taxpayer and a nonelecting taxpayer become
22 members of a new unitary affiliate group, the nonelecting taxpayer
23 shall be deemed to have elected if the value of the total business
24 assets of the electing taxpayer, and its component unitary group,
25 if any, is larger than the value of the total business assets of the
26 nonelecting taxpayer, and its component unitary group, if any.
27 Otherwise, the water's-edge election shall be automatically
28 terminated at the time the electing members become part of the
29 combined report. For purposes of applying paragraphs (9) and
30 (10), the commencement date of the deemed election shall be the
31 same as the commencement date of the electing taxpayers.

32 (3) If taxpayers filing under water's-edge elections with
33 different commencement dates become members of a new unitary
34 affiliate group, the earliest election date shall be deemed to apply
35 to all electing taxpayers if the total business assets of the earlier
36 electing taxpayer, and its component unitary group, if any, is larger
37 than the value of the total business assets of the later electing
38 taxpayer, and its component unitary group, if any. Otherwise, the
39 later election commencement date shall apply to all electing
40 taxpayers.

1 (4) (A) If a taxpayer with an election that has been terminated
2 under paragraph (9) or (10) becomes a member of a new unitary
3 affiliate group that includes another electing or nonelecting
4 taxpayer not affected by those paragraphs, any water's-edge
5 election of the other taxpayer member, if applicable, shall
6 terminate, and any restrictions on making a new water's-edge
7 election, relating to an election terminated under those paragraphs,
8 shall apply to all taxpayer members of the new unitary affiliate
9 group if the total business assets of the taxpayer with the
10 terminated election, and its component unitary group, if any, is
11 larger than the other taxpayer, and its component unitary group, if
12 any. Otherwise, paragraph (2) shall apply, if applicable. If
13 paragraph (2) does not apply, all taxpayer members of the new
14 unitary affiliate group will be treated as nonelecting taxpayers that
15 are not subject to any restrictions on making a new water's-edge
16 election.

17 (B) If two nonelecting taxpayers with different termination
18 dates under paragraph (9) or (10) become members of a new
19 unitary affiliate group, the earliest termination date shall be
20 deemed to apply to all nonelecting taxpayers, as well as any
21 restrictions on making a new water's-edge election relating to that
22 termination, if the total business assets of the earlier terminating
23 taxpayer, and its component unitary group, if any, is larger than the
24 value of the total business assets of the later terminating taxpayer,
25 and its component unitary group, if any. Otherwise, the later
26 termination date, and the related restrictions on making a new
27 water's-edge election, shall apply to all taxpayer members of the
28 new unitary affiliate group.

29 (5) (A) Except as provided in subparagraph (B), if one or more
30 electing taxpayers did not report their income and apportionment
31 factors as members of a combined reporting group with one or
32 more nonelecting taxpayers, and, pursuant to a Franchise Tax
33 Board audit determination, the nonelecting taxpayers, are properly
34 in the same combined reporting group as the electing taxpayers,
35 the water's-edge election of the electing taxpayers shall remain in
36 effect and the nonelecting taxpayers shall be deemed to have made
37 a water's-edge election. The commencement date of the deemed
38 water's-edge election shall be the same as the commencement date
39 of the electing taxpayers.



(B) Subparagraph (A) shall not apply if the value of total business assets of the electing taxpayers does not exceed the value of total business assets of the nonelecting taxpayers. In that event, the water's-edge election of each electing taxpayer is terminated as of the date the nonelecting taxpayers are, pursuant to the audit determination described in subparagraph (A), properly included in the same combined reporting group as the electing taxpayers.

(C) For purposes of applying the business asset test of this paragraph, the term "business assets" shall have the same meaning as subparagraph (A) of paragraph (6), except that the business assets of other members of the unitary affiliate group that are not taxpayers shall not be taken into account.

(D) Notwithstanding subparagraph (A), nonelecting taxpayers may not be deemed to have made a water's-edge election if the Franchise Tax Board audit determination described in subparagraph (A) is withdrawn or otherwise overturned.

(6) For purposes of paragraphs (2) to (5), inclusive, the following shall apply:

(A) "Business assets" are assets, including intangible assets, other than stock of a member of the unitary affiliate group, which are used in the conduct of the business of the unitary affiliate group or would produce business income to the unitary affiliate group, if an election were not in place, if the assets were sold. Business assets shall be valued at net book value.

(B) The phrase "unitary affiliate group" refers to all of those corporations that would constitute a unitary group if a water's-edge election were not made.

(C) The phrase "new unitary affiliate group" refers to a unitary affiliate group that is created by a new affiliation of two or more corporations, or by the addition of one or more new members to an existing unitary affiliate group.

(D) The phrase "component unitary group" means that portion of a group of corporations that have become members of a new unitary affiliate group that were members of their own respective unitary affiliate group prior to entering the new unitary affiliate group, disregarding any corporations that did not become part of the new unitary group.

(7) In the application of paragraphs (2) to (4), inclusive, a series of acquisitions as steps of a single transaction shall be aggregated as a single change of membership.

(8) In the event of a merger or consolidation, the water's-edge status and election commencement date or termination date of the surviving corporation shall be consistent with the result that would have been obtained under paragraphs (2) to (4), inclusive, if the surviving corporation had acquired the stock of the transferor corporation.

(9) A water's-edge election may be terminated without the consent of the Franchise Tax Board after it has been in effect for at least 84 months. The termination shall be made on an original, timely filed return for the first year in which the water's-edge election is to be terminated. To be effective, the termination shall be made by every taxpayer that is a member of the water's-edge group in the same manner as the election provided under subdivisions (a) and (b).

(10) A water's-edge election may be terminated before the 84-month period described in paragraph (9) has elapsed, but only with the consent of the Franchise Tax Board. A request for termination shall be made at the time and in the manner specified by the Franchise Tax Board. The request may be granted for good cause. For purposes of this section, good cause shall have the same meaning as specified in Treasury Regulations Section 1.1502-75(c).

(11) Except for deemed elections as provided in paragraphs (2), (4), and (5), if a water's-edge election is terminated under paragraph (9) or (10), another election may not be made under this section for any taxable year that begins within the 84-month period following the last day of the election period that was terminated. The Franchise Tax Board may waive the application of this prohibition period for good cause.

(12) A water's-edge election shall remain in effect until terminated.

(d) For purposes of this section, the following shall apply:

(1) A "combined reporting group" means those corporations whose income and apportionment factors are properly considered pursuant to this chapter in computing the income of the individual taxpayer that is derived from or attributable to sources within this state, taking into account a valid water's-edge election.

(2) A "group return" refers to the single return which taxpayer members of a combined reporting group may elect by contract to

1 file, in the form and manner prescribed by the Franchise Tax
2 Board, in lieu of filing their own respective returns.

3 (3) A “self-assessed combined reporting group” means that
4 group of corporations whose income and apportionment factors
5 are reflected in a combined report prepared pursuant to this chapter
6 in a timely filed return, taking into account the effects of a
7 purported water’s-edge election, whether or not the membership
8 of the corporations in that combined report was correctly
9 determined.

10 (e) The Franchise Tax Board may prescribe any regulations as
11 may be necessary or appropriate to carry out the purposes of this
12 section.

13 (f) To the extent that a taxpayer would have been required to
14 file on a water’s-edge basis in its first taxable year beginning on
15 or after January 1, 2003, pursuant to a water’s-edge election made
16 in a prior year under Section 25111, the terms of Section 25111
17 shall not apply and the election shall be deemed to have been made
18 under the terms of this section. However, the commencement date
19 of the election made in a prior year under Section 25111 shall
20 continue to be treated as the commencement date of the
21 water’s-edge election period for purposes of applying this section.

22 ~~SEC. 5.—~~

23 *SEC. 8.* Section 25116 is added to the Revenue and Taxation
24 Code, to read:

25 25116. Notwithstanding paragraph (1) of subdivision (a) of
26 Section 23051.5, when provisions of this article refer to provisions
27 of the Internal Revenue Code that do not otherwise apply for
28 purposes of Part 10.2 (commencing with Section 18401) or this
29 part, the term “Internal Revenue Code” means Title 26 of the
30 United States Code, including all amendments thereto, as in effect
31 for federal purposes for the taxable period, except as otherwise
32 specifically provided in this article.

33 ~~SEC. 6.—~~

34 *SEC. 9.* This act provides for a tax levy within the meaning
35 of Article IV of the Constitution and shall go into immediate
36 effect.

